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Globalization and the Limits to National Economic Management

by

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ABSTRACT

The emerging world environment with relatively freer flows of goods and finance has tremendous implications for macroeconomic management. Among others, both direct fiscal and monetary control are more difficult in an environment where individuals and firms have much greater ability to rearrange their portfolios, even across national borders. Under these conditions, policy makers must depend less on direct control over macroeconomic magnitudes and count more on influencing the fundamental factors affecting macroeconomic changes.

Globalization and the Limits to National Economic Management

by
Cayetano Paderanga, Jr.[1]

There has been a world of difference before and after the Asian currency crisis. In the first half of 1997, one could make the case that the case for keeping the economy open to the outside world was not difficult to make. The Asian dragons and Chile and the emerging countries of Southeast Asia had been doing very well for the last few years. Asia, including Southeast Asia (i.e. the ASEAN four, Singapore, Malaysia, Thailand, Indonesia with the Philippines following closely), was expected to dominate the world's economic developments for at least the first part of the twenty-first century. That encouraging picture has become open to question. As of the middle of 1998 Southeast Asia, is still experiencing the turmoil of currency adjustments. The economic outlook for the region while still positive is no longer as rosy. Doubts also linger about South Korea's immediate future.

What has made that difference? The underlying economic structures could not have changed so fast as to create almost the mirror-image of the former picture. What changes in the environment, the perception, and some economic variables could have brought the sudden shifts in fortune? We will examine how such a rosy picture could have emerged and how it could also complete change in a very short time. More fundamentally, we ask how the emerging world environment allows such radical changes in economic fundamentals or perceptions to take place, The analysis may suggest how to respond to the opportunities and mitigate the dangers in the emerging world environment.

I. The Logic of Financial Globalization

Global financial integration

In the last few decades the increase in global trade has also resulted in much greater financial flows. Although net flows of global capital may be smaller than at the turn of the century, gross international financial flows are much bigger, i.e. total financial trade has increased tremendously although this has coincided with economies borrowing and lending from each other (Figure 1). Another dimension of this phenomenon is the rapid development in financial instruments and technology. Data show that while growth in trade has increased at slightly higher than 5 percent from 1980 to 1996, trading in bonds and equities and trading in currencies have increased by close to 25 percent annually (Tables 1 and 3).

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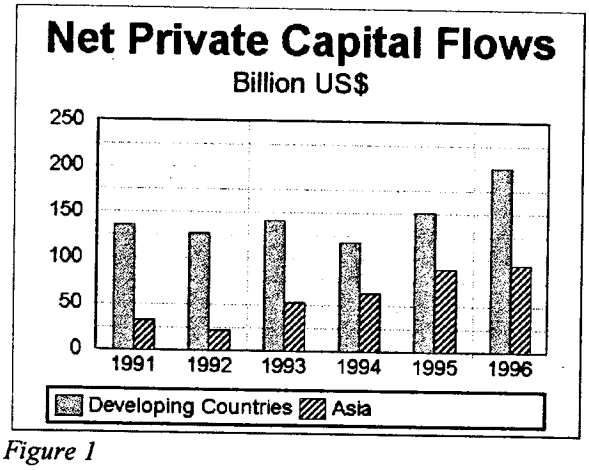

Figure 1

Increase in capital flows

Starting in the 1970's, the restrictions on international capital movements slowly became loosened. During most of that decade, private flows of capital mostly through commercial banks to governments in developing countries increased tremendously in order to take advantage of the perceived security of sovereign risk. This was partly in response to the "recycling problem" of the pedro-dollars which oil producing countries had been accumulating. The succeeding "debt problem" of the 1980's took away trust in sovereign risk and there was a short hiatus in capital flows.

Gradually, though, the dismantling of capital and exchange controls in the 1980's, accelerating in the 1990's, coincided with an intense period of deregulation of domestic financial markets. The technological innovations in telecommunications and financial techniques mentioned earlier, enhanced the impact of the policy changes. The resulting liberalization of financial markets together with the decline in transactions costs and the emergence of new financial instruments resulted in a dramatic growth in cross-border financial transactions (IMF, 1997).

Table 1 shows the increase in cross-border transactions in bonds and equities. For some advanced countries, this increased by at least 1,500% as a share of gross domestic product between 1980 and 1996. Among other factors, this represents an explosion in the participation by developed country private investors and investment funds in emerging markets, indicating increased interest in financing business activities in other parts of the world.

This flow of equity and loan capital has been reflected by increased (outward) direct foreign and portfolio investment (Table 2). Indicating the expansion of the international activities of multinational enterprises, this growth in foreign direct investment as a proportion of the country of origin's gross domestic product is a reflection of the increasing globalization of business in recent years.

Table 1
Cross-Border Transactions in Bonds and Equities
(In percent of GDP)

	1970	1975	1980	1985	1990	1995	1996
United States	2.8	4.2	9.0	35.1	89	135.3	151.5
Japan	-	1.5	7.7	63	120.0	65.1	82.8
Germany	3.3	5.1	7.5	33.4	57.3	169.4	196.8
France	-	-	8.4	21.4	53.6	179.6	229.2
Italy	-	0.9	1.1	4	26.6	252.8	435.4
United Kingdom	-	-	-	367.5	690.1	-	-
Canada	5.7	3.3	9.6	26.7	64.4	194.5	234.8

Source: Bank for International Settlements (BIS)

Table 2
Gross Foreign Direct Investment plus Portfolio Investment
(In percent of GDP)

	1970-74	1975-79	1980-84	1985-89	1990-95
Belgium-Luxembourg		3.4	5.1	14.3	41.5
Canada	1.7	3.4	3.6	6.1	7.2
Denmark		0.6	0.9	3.5	7.2
France		1.3	2.1	4.1	7.2
Germany	1.2	1.3	1.7	5.2	6.3
Italy	0.9	0.3	0.6	1.7	5.7
Japan		0.6	2.6	5.9	3.7
Netherlands	7.3	4.7	6	10.9	11.1
Norway		5.6	0.4	6.6	2.1
Portugal		0.4	1	3.6	6.3
Spain		0.7	1.2	3.1	6.7
Sweden	1	1.2	1.7	5	7
Switzerland		4.5	9.4	14.7	12.8
United Kingdom	3.6	4	5.4	14.4	11.9
United States	1	1.5	1.4	2.9	3.3

Source: Bank of International Settlements

To service the increasing financial interaction among market players in the world, the currency markets have also increased at an accelerating rate. Table 3 shows how global currency turnover has increased by 600% in the ten-year period, 1986-1995.

Table 3
Foreign Exchange Trading
(In billions of U.S. dollars and in percent)

	1979	1986	1992	1995
Global estimated turnover	188	590	820	1190
As a ratio of:				
World exports of goods and services	7.4	15.8	17.4	19.1
Total reserves minus gold (all countries)	36.7	75.9	86.0	84.3

Sources: Bank of International Settlements; and International Monetary Fund

It is interesting to compare this episode of capital market integration with the previous episode which occurred in the gold standard era before 1914. During that period, capital flows from Great Britain represented about 9% of gross national product with similar proportions for France, Germany, and the Netherlands. Much of the flows went into bonds financing railroads and other infrastructure in the new world (especially the United States and Canada). In contrast, the peak current account surpluses of Japan and Germany in the mid and late 1980's represented only 4-5% of gross domestic product (IMF, 1997:page 165).

The difference in the character of the financial integration during the two episodes is significant. From initial appearances, this most recent episode is characterized by a pronounced dominance of currency transactions over capital flows. This indicates the fundamental change in the character of enterprises and production technology: driven by lower transportation, communication and computing costs, firms have increased their ability to combine the lowest production costs located at far-flung geographical points in order to attain the cheapest total cost of production. This has led to lower production costs all around and, because of the increased competition resulting from the same developments, lower prices for customers. It has also increased competition among more producers in a much larger global market, leading to heightened insecurity for firms and workers.

Flows to developing countries

International financial flows has included developing countries among their destinations although this has been lopsided in favor of some developing areas. Technological innovations and the abolition of capital controls coincided with depressed economic conditions, low interest rates and a relative dearth of investment opportunities in the OECD economies. Combined with relatively high expected returns on equities in Asian markets, these made conditions ripe for dramatic shifts in the allocation of investment funds around the world. Table 4 shows that aggregate net long-term resource flows to developing countries has more than doubled from 1990 to 1995. Total private capital flows during that period has increase four times during the same period.

Table 4
Aggregate resource and net private capital flows to developing countries

Category	1990	1991	1992	1993	1994	1995
Total private	44.0	61.6	100.3	154.2	158.8	167.1
Portfolio investment	6.7	20.4	27.3	83.9	67.1	55.7
Debt flows	3.0	12.8	13.2	38.3	32.2	33.7
Equity flows	3.7	7.6	14.1	45.6	34.9	22.0
Foreign direct investment	25.0	35.0	46.6	68.3	80.1	90.3
Commercial banks	1.7	2.5	13.8	-4.9	9.2	17.1
Other private	10.6	3.7	12.6	6.9	2.4	4.0
Aggregate net long-term resource flows	101.9	127.1	155.3	207.2	207.4	231.3
Private capital flows as a percentage of aggregate net long-term flows	43.2	48.5	64.6	74.4	76.6	72.2

Source: Various World Development Reports

Flows to East Asia and the Pacific

The increase in net long-term resource flows to developing countries has been at a phenomenal rate -- external resource inflows have increased from 2% of the GNP of developing countries in 1988 to 4.2% in 1995. Figure 1 compares the Net Private Capital Flows to all developing countries and to Asia. This indicates that there has also been a response to the increasing bright prospects for future growth in Asia. For example, in 1994, developing countries in Asia grew by an average of 8.2 percent.

A similar pattern is manifested in foreign direct investment flows. Table 5 shows that flows of foreign direct investment to developing countries grew two and one-half times from 1990 to 1995. However, during the same period, the flows to East Asia and the Pacific grew three and one-half times, implying that other developing areas were not as desirable destinations for foreign investment. In contrast, flows toward Sub-Saharan Africa, the Middle East and North Africa, and South Asia. The first two areas have been wracked by political instability while South Asia is only now starting to relax extensive regulations and open up their economies to the international market.

Table 5
Annual average FDI flows to developing countries, by region (US$ Million)

Region	1990-92	1993-95	1994	1995
All developing countries	35,532	79,576	80,120	90,346
Of which:				
Sub-Saharan Africa	1,396	2,309	2,987	2,187
Asia	16,024	46,427	44,279	55,749
East Asia and Pacific	15,509	44,871	43,037	53,703
South Asia	515	1,376	1,242	2,046
Europe and Central Asia	4,254	9,727	8,362	12,482
Eastern Europe and Central Asia	2,340	7,978	6,684	10,595
Rest of Europe	1,914	1,749	1,678	1,887
Latin America and the Caribbean	11,638	18,104	20,811	17,799
Middle East and North Africa	2,221	3,189	3,681	2,129

Source: Various World Development Report

The lopsided flows of capital flows is manifested in the size of net resource flows in proportion of the gross national products of countries in East Asia and the Pacific, especially the ASEAN four (Table 6).

Table 6
Aggregate net resource flows as % of GNP

	1980	1994	1995
East Asia and the Pacific	2.9		7.8
Philippines	3.9	6.9	5.2
Thailand	6.5	.3	6.1
Indonesia	2.5	5.4	6.8
Malaysia	8.7	10.2	14.7

Source: World Development Report, 1996, 1997

The larger portion of the increase have resulted from a surge in private capital flows towards the private sector in recipient countries. Private capital has dominated the inflows, accounting for about 75% of the regions's net external inflows from 1991-94. Foreign direct investment and portfolio equity investment have been the most important forms of private capital flows. Net foreign direct investment increased from $12.1 million 1991 to $54.8 while net portfolio investment grew from $0.5 billion in 1991 to $9.2 billion in 1994. The share of multilateral and bilateral official sources of finance have declined sharply from 38% in 1991 to 15% in 1994. These flows have been mediated by the equity and debt markets of recipient countries which have enjoyed bullish behavior over the last few years. For example, the East Asian stock markets, measured in US dollars, have seen their capitalization

increase by 241 percent from 1990 to 1994.[2] East Asian economies attracted 82% of the net long-term external resource flows into the region in the 1990's. In contrast, South Asian economies has continuously relied on official sources of finance.

Financial liberalization, "The baby ...."

It is, perhaps, important to remember why liberalization and market-orientation are undertaken in the first place. In a recent paper in the Economist, Sachs (1997) stated that "openness was decisive for rapid growth. "Open economies grew 1.2 percentage points per year faster than closed economies, controlling for everything else." Krugman (1987), one of the foremost "new trade economists" who have provided the arguments for theoretical deviations from free trade, asserted that, given all the uncertainties introduced by lags and imprecision about information, recognition, and implementation, freer trade would still be the best guide for economic management. The record of ASEAN economies and the newly-industrialized countries (NICs) since the second world war and that of the Philippines in the past few years attest to the advantages of allowing freer commerce with the rest of the world and letting the market determine the allocation of resources.

Liberalization and the flow of capital funds have been very beneficial for developing countries including the Philippines. Liberalization facilitates the flow of goods and services which transmits the benefits of specialization, economies of scale and other benefits of freer trade. Private funds provide much needed capital allowing these countries to bypass the temporal inconsistency of having very high-return projects including infrastructure at the same time that they lack the resources to undertake them. Their integration to international capital markets allow them to smooth the temporal imbalances between the need and availability of investment resources. For a country with large and expanding social service needs, this allows the government to plan heavy investments while reducing the need to contract social services.

Among the many consequences of the Philippine economic recession more than ten years ago was a drastic reduction in the investment and saving rates which are slowly recovering only now (see Figures 2 and 3). Capital flows provides a substantial source of spontaneous, private sector funds for the much needed capitalization and re-tooling for our economy. It also enriches the available instruments and strengthens the environment for the mobilization of domestic resources. Our research at the Bangko Sentral (Tan and Paderanga, 1997) shows that while the Philippine economy is not yet fully integrated with the rest of the world, the degree of integration has increased in the last few years.

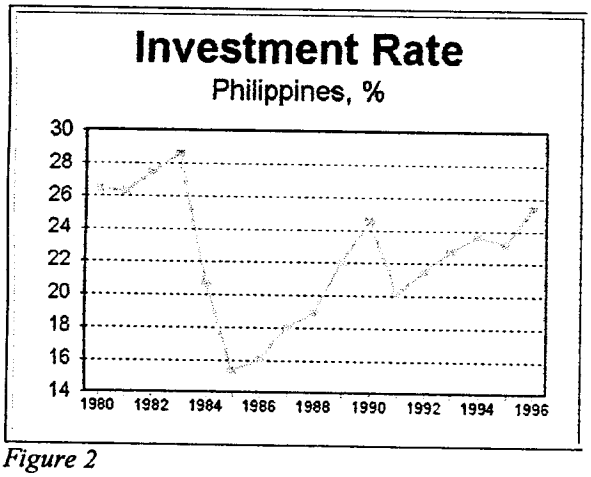

Figure 2

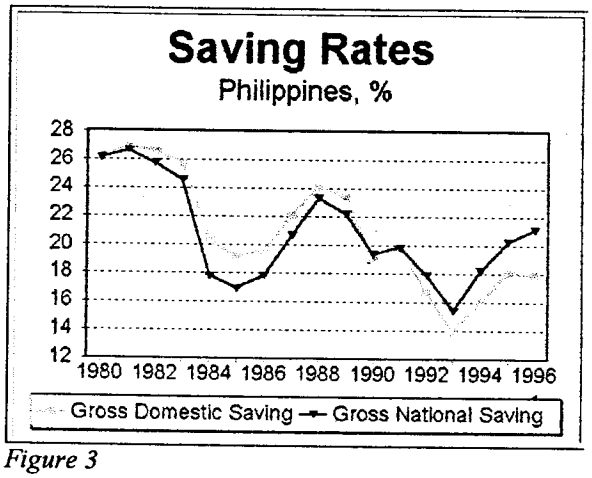

Figure 3

[2]This includes China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand.

At the same time, every silver lining has a cloud. Substantial short-term capital flows were attracted in the 1990's, averaging a little over $10 billion per annum resulting in, among other things, a rapid accumulation of foreign exchange reserves. Large foreign capital inflows have positive and negative effects. Employed in productive activities, capital flows permit higher investment even in excess of current domestic saving. However, large capital inflows may make macroeconomic management more difficult. The recent turmoil in the Southeast Asian currency markets is only the latest reminder of the complications that come from the entry of highly volatile capital flows. These developments move us to consider the impact of financial integration on macroeconomic and monetary management.

Financial integration also provides some benefits in the financial front. Three immediately come to mind. First, it helps develop the financial sector itself. The resulting lower cost of capital and efficiency in financial services are expected to benefit the economy as a whole. Second, It increases the available financial instruments available to firms and individuals for efficiently achieving their desired portfolio balances. It also provides clear signals to economic managers as to how their decisions and plans are perceived. Finally, the flow of capital will enable economies to unbind their consumption and financial decisions. For example, financial integration facilitates the ability of countries to undertake significant investments during their early growth phases, when most probably they have not yet attained the income level corresponding to the required saving rate.

II. The Illogic of Financial Globalization

".... and the bath water."

At the same time, the turmoil in Southeast Asian foreign exchange markets in the last few months highlights one of the consequences of open economies and integrated financial markets. "Global capital markets... are dispassionate, brutally calculating and... fickle ..." (Hirsh and Powell, 1997). Smooth and rapid movements in one direction can suddenly reverse catching individuals and firms unprepared. Those caught with the wrong judgements can suffer large losses. While these markets provide economic activity and resources, economic managers need to be nimble enough to adjust to their unpredictable ways.

Innovation in the financial sector

One of the sources of unpredictability stems from the possibility that domestic markets will be affected by what happens in other countries, in the same way that the Mexican peso crisis and the overall currency movements in Southeast Asia today have affected Philippine financial markets. This phenomenon of contagion among countries has increased in frequency since the increase in financial integration of emerging markets in the 1980's.

Technological innovations in communication, information processing and transportation now allow investors to operate in financial markets around the world, allowing them to accomplish portfolio allocation around the world throughout the day. In fact, large banks and financial firms now do this as a matter of course.

Advances in financial theory have allowed a much expanded array of financial instruments. This has led to increased ability by firms to pass on the financial chore to third parties and concentrate on their core activities, leading to increased specialization and efficiency. The availability of financial instruments also reduces the cost of liquidity and capital. The tradeoff is that financial firms now operate at much thinner margins (good) and with higher leverage (bad), sometimes imperceptibly. That is, new financial instruments allow entities to participate at much smaller entrance costs but also increases the possibility that market reversals will rapidly eat into core capital. These new instruments also increase the ways that market actors can evade direct control by policy makers of financial symptoms (as contrasted with the management of fundamentals).

The combination of wider financial reach, speedier transactions, more complicated and numerous financial instruments, and the possibility of higher leverage, have all combined to increase the probability of rapid financial market meltdowns spreading globally or within geographic regions.

The international financial market players

The changes in the international financial market are absorbed by a framework that includes the market players. Table 7 shows the balance of payments of the Philippines for 1997. It also summarizes the main types of actors operating in the foreign currency and financial markets.

Table 7
Balance of Payments, 1997[3]
In Million US Dollars

I. Current Account	
A. Trade	-5383
Goods	-11127
Exports	25228
Imports	36355
Services	5744
Receipts	22835
Payments	17091
B. Transfers	1080
Inflow	1670
Outflow	590
Current Account	-4303
II. Capital and Financial Account	
A. Medium and Long-Term Loans	4688
Availment	7427
Repayment	2739
B. Trading Bonds in the Secondary Market	-676
Resale of Bonds	3072
Purchase of Bonds	3748
C. Investments	766
Non-Resident Investments in the Phil.	847
Resident Investment Abroad	81
D. Short-Term Capital	495
E. Change in Commercial Banks' NFA	1191
Capital and Financial Account, Net	6464
III. Others	-360
A. Monetization of Gold	105
B. Revaluation Adjustments	-465
IV. Net Unclassified Items	-5164
V. Overall BOP Position	-3363

Source: Bangko Sentral ng Pilipinas

[3]Preliminary

The first balance, the trade account, summarizes the activities of exporters and importers who buy and sell goods in the world market. Both types of players respond in the medium and long-term to changes in the real effective exchange rate — i.e. some benchmark exchange rate between the domestic currency and the world currency (currently, primarily the U.S. dollar) adjusted for changes in the relative cost of doing business (as indicated by the changes in relative price indices). However, as the date for settling transactions and obligations approach, they start to second-guess the market exchange rate in an effort to pinpoint the best time to carry implement their payments.

The international sales and purchases of services together with unilateral net transfers (e.g. bequests, and gifts) are added to the trade account in order to arrive at the current account. For the Philippines, a large portion of the services inflow comes from the earnings of overseas Filipino workers. These workers generally base their decisions on the level of compensation abroad relative to their expected domestic income. But just like exporters and importers, they also speculate on the exchange rate to time their remittances to the Philippines. Most of the other services income, is made up of financial, insurance and telecommunications services.

The next portion of the balance of payments is the capital account. The main components are long and short-term investments and loans. An important part of long-term investments is foreign direct investments. The main factors involved are the long-term consideration of doing business in the country such as political, labor and policy stability and comparative cost of doing business.

On the other hand, portfolio investments from abroad depend mostly on the differential between the international and domestic returns adjusted for expected changes in the exchange rate. Expectations about exchange rate changes introduce volatility in the flow of capital funds in largely the same manner that it affects the short term behavior of exporters, importer, and overseas workers. Slight changes in market sentiment sometimes result in large fluctuations as individuals rush to correct the composition of their holdings. International fund managers who manage the major portion of these funds are able to propagate very rapidly the implementation of these market changes.

The integration of the international financial market is most articulated in the activities of the international investment funds. While there are various types of funds - classified by tenor (i.e long or short-term), by industry, type of instrument (bonds, equities, etc.), and others -- the strategy of investing in the global market is roughly similar for all. At the center of each fund or umbrella group is an international investment committee which allocates funds by geographical region. Research studies country manager reports and other information flow to the investment committee which may then revise its allocation. If these investment funds implement their revisions coincidentally or nearly so, individual countries' currency markets may experience substantial fluctuations. Furthermore, very short-term speculation on the movements of individual currency exchange rates is one instrument in the income generating paraphernalia of these funds. When the conditions are appropriate, these fund movements may actively or unintentionally undermine specific exchange rate levels.

In the presence of the increased volatility, the ability of national economic managers to directly control the fluctuations has been eroded. The instruments left for the policy makers are those for strengthening the fundamentals of the currency market. This may include provisions for greater transparency, stable policies and prudent behavior by financial and related institutions.

Multilateral financial institutions such as the International Monetary Fund (IMF) and the World Bank, as well as countries like the United States, may be able to provide support for the effective management of the currency exchange rates. The IMF, tasked with the maintenance of an effective international payments mechanism often intervenes with short-term financing to allow countries to ride over temporary difficulties. Recently, it has also orchestrated international rescues for countries under severe exchange difficulties, as in the 1994 Mexican crisis and Asian currency crisis. The World Bank with its loan portfolio available for development projects has also used its macroeconomic adjustment programs to assist in currency rescue operations.

The phenomenon of contagion

A recent example of the increasing danger of currency meltdowns due to contagion is the ASEAN currency crisis. Political problems in Thailand in late 1996 triggered emerging doubts about the sustainability of its high growth

rate. A series of speculative attacks on the baht which soon followed were at first held at bay by using its relatively large international reserves. A full-blown assault on the currency in May 1997 was repulsed with the participation of neighboring ASEAN central banks. However, incessant probes finally succeeded on July 2, 1997 when Bank of Thailand was forced to free the baht from its effective peg to the U.S. dollar. The Philippines soon followed on July 11. These events initiated a continuing series of exchange rate corrections among ASEAN currencies and the South Korean won.

The way the turmoil spread within the region has induced interest in newer explanations of contagion in international financial markets. Calvo (1995) analyzed the impact of investor herd behavior in international financial markets due to asymmetric information across national borders. When an initial exchange rate correction is experienced within a region, foreign investors who invest on the basis of broad regional indicators and have not gone into more detailed analysis of individual countries are unable to distinguish between currencies. There is a tendency to escape from the region as a whole rather than make distinctions between individual currencies.

Frankel and Schmukler (1996) have also studied contagion through changes in the net asset values of investment funds and the resulting portfolio re-allocating. As exchange rate corrections reduce the net asset value of the portfolio, investment managers are induced to liquidate investments in some regions in order to realize gains to balance reductions in "losing" regions. Other researchers have also studied how fundamentals can change with shifts in market perception.

The speed of contagion in the recent Southeast Asian turmoil has been ascribed to competitive devaluation, not by policy makers but as self-fulfilling expectations by market players. Given the stability of the exchange rate of these currencies to the U.S. dollar and the slowdown in the growth of their exports. There had been widespread speculation that these countries had lost competitiveness over the last few years. When the U.S. dollar appreciated substantially relative to the German DM and the Japanese yen during the first six months of 1997, the expectations for exchange rate corrections became acutely heightened.

The ASEAN currency turmoil has now spawned a line of research based on market reactions and expectations of competitive devaluation by market players. The speed of contagion and the indeterminateness of the final outcome are the main concerns in this line of inquiry.

Impact on macroeconomic management

The integration of financial markets, manifested among other things by perceived increase in susceptibility to currency disturbances and by the speed of contagion, also changes the effectiveness of monetary and other macroeconomic policies. In a nutshell, monetary and credit control is diminished, the degree of diminution depending on the exchange policy chosen, and more use of fiscal and related policies have to be resorted to. A changing menu with varying with varying proportions among the major policy components --- monetary, fiscal, trade and others --- require more sophisticated financial markets as well as analysis and planning.

Two immediate issues immediately come to mind. First, an economy needs to decide how to handle the flow of funds through national borders in response to variations in market confidence about a country's immediate or intermediate prospects. Even in the case of inflows, the knowledge of what could happen when market sentiments reverse pose difficult dilemmas for economic managers. Second, the practice of macroeconomic management itself may have to change in the emerging economic environment.

Market perception and the sequence of economic liberalization

The experience of the Southern Cone economies in the early 1980's and recent research (e.g. McKinnon, 1993) imply that as economies go through economic restructuring and stabilization, the market value of domestic firms increases and, if investment rules and foreign exchange transactions are liberalized, become attractive to foreign investors. Private investors and domestic borrowers often underestimate the risks of credit laxity as they jostle to be ahead of the pack. Both lenders and borrowers are caught in a collective myopia about how much more borrowing the economy can afford. The system limits can sometimes be opaque to market participants. Further, moral hazard

problems posed by deposit insurance may induce banks to lend more than safe limits. The result can be the phenomenon that McKinnon and Pill (1996) call the over-borrowing syndrome, leading to the possibility of "Dutch disease" in the real structure of the economy and over extension in the financial sector.

In what is now called the "Dutch disease," an overly strong inflow of foreign exchange leads to a very strong domestic currency which reduces the competitiveness of domestic products in world markets. The cause of the original inflow could come from newly discovered resources such as the North Sea oil fields in the original case of the Netherlands or, as in the recent case of emerging markets, a revival of confidence by investors in newly-reforming countries. The resulting demise of export industries (and domestic import-substituting firms) seriously hamstrings the country when market sentiments reverse and the problem is now an outflow and a dearth of foreign exchange.

The over-borrowing syndrome, as is now seen in the case of Southeast Asia, leads to weak financial and banking sectors which also threaten economic stability when the flow of funds reverse direction.

Effectiveness of macroeconomic policy tools

The literature on open economy macroeconomics has provided managers with some answers on how market openness and financial integration modify the expected effects of the various monetary instruments. For example, college students now know that with fixed foreign exchange rates, monetary authorities essentially lose effective control over the volume of money supply. With full financial integration, domestic control over interest rates becomes weak. Thus, the influence over economic activity of most of the monetary instruments are much reduced. Other approaches to foreign exchange management modify this result but the conclusion remains; in an integrated global environment monetary micro management by the government loses much of its force.

One implication on economic management, and one often most quoted in undergraduate texts, namely, that under fixed exchange rates "monetary policy becomes ineffective and fiscal policy becomes important," [and that under flexible exchange rates "fiscal policy is weak and monetary policy is powerful."] can actually be dangerously overstated. While each policy is relatively more important than the other under different exchange rate regimes, the fact is that with full financial integration both policies are weakened by the increased ability of economic resources to relocate and avoid the effects of policies. The corollary is that these policies may have unwanted side-effects that economic managers ignore only at their own risk.

The second implication has to do with the character of monetary and exchange management. Before, economic managers could and often directly controlled capital and other flows through regulations and directives. With increased integration and innovative financial instruments, the ability of residents and foreign investors to balance their portfolio among local and foreign assets have eroded the authorities' control over monetary, credit and currency flows.

Under these circumstances, economic managers can no longer expect to control monetary and currency magnitudes as tightly as before. Market actors are now able to respond independently to prices and underlying trends. They find ways around restrictions which are inconsistent with market signals and economic resources now rapidly migrate according to market intentions. This implies that economic managers can no longer command and must shift towards keeping the fundamentals right. The whole framework of policy making must now turn towards keeping the prices, structures and institutions conducive for market activities instead of trying to influence the volume of flows directly. One may characterize the best way to manage the economy as the "back to basics" approach.

Effect on the practice of economic management

A period of "retrenchment" and reflection is now needed by economic managers. This is especially true in the face of the seeming inevitability and irresistibility of the recent currency crisis. Managers now need to know exactly what they can do and what they will have to leave to the market and to the normal course of economic activity. A whole new agenda of research for economic managers seem to have opened up in the face of the changing world economic environment.

Among the first things economic managers need to find out are what the remaining monetary, fiscal and other instruments are left for them to use and how effective each of these are under different circumstances. Given the instruments at their disposal, what should be the objectives of macroeconomic policy. While it may still be useful to think about the same broad objectives of stability, low inflation, growth, equity and others which we had before the significant changes in the environment, the intermediate and operational targets may have to be modified.

Current economic ideas as well as institutional and market realities combine to influence how macroeconomic management is carried out. For example, with many exceptions one can generalize monetary management in the late 1960's and seventies as interest rate targeting. In the eighties, this shifted to money supply targeting. Now in the nineties, there are suggestions to formally describe it as inflation targeting, especially in the face of many central banks being reorganized and given specific mandates to keep inflation low. Considering the new circumstances, there seems to be no doubt that the character of economic management has to change. For example, in the face of financial integration, how sustainable would an interest rate target diverging from world interest rates be in the medium and long term? While a high saving rate would still be desirable in order to remain on a high growth path, the return incentive may have to be stated in a slightly different way[4] and the means of achieving that may be different[5].

The objectives of macroeconomic management.

In such an environment, the objectives of macroeconomic management need to be modified. Some direct objectives may no longer be sustainable in the long run. For example, a government's ability to set tax levels in order to shape its tax structure may be curtailed by the consideration of how this may affect saving and investment rates in the economy. While this has always been a consideration, the limits are narrower in a world where individuals' ability to revise their portfolios are greatly enhanced.

The effect on economic managers' ability to control and their flexibility in the short-run is unambiguous: these are severely curtailed in the new environment. The ultimate effects on long-run economic effectiveness could go either way. The beneficial results could come in two forms. First, because leeway in economic actions (for example, contractionary or expansionary) is restricted, the degree of reversal and the attendant pain of adjustment is also dampened. Second, the restriction of leeway reduces the temptation for economic managers to achieve short-term gain at the expense of long-run deterioration, known in the economic literature as the "time inconsistency problem." Both these factors could lead to less frequent and less pronounced fluctuations, making the environment more stable and predictable for individual market players.

In sum, however, these changes portend less flexibility and control on the part of economic managers. On the downside, managers have less powers available to judiciously counteract business cycles.

Effect on economic institutions

The force and the implications of the new environment on policy making imply and have already been inducing changes in economic institutions. Governments, seeing the benefits accorded by financial integration, may be willing to incur some of the costs. One form of these costs is reduced freedom and flexibility in the design of economic institutions, including laws and regulations pertaining to how economic activity is carried out. Ahead of all these are the requirements for "transparency" and "openness" in government processes (including how they make and implement decisions). Countries have also started to modify their institutions in order to conform with internationally

[4]For example, through differential taxation between consumption and saving.

[5]In the same way, inducements for domestic and foreign direct investments may take the form of higher infrastructure and efficient support services.

accepted forms of regulation and monitoring. For example, more and more developing countries are setting up stock and other financial exchanges together with their regulating institutions such as securities and exchange commissions. Maxfield (1997) has also documented how developing countries have been passing legislation to make their central banks legally "independent."

The institutional changes required by financial integration have implied, first, that governments now have less leeway in the design of their economic institutions and, second, that some form of uniformity in the structure of economic institutions may be expected to take place. How these will curtail government's ability to respond to the unique requirements of their culture and traditions is still to be seen[6]. How individual countries and populations respond to the rapidly increasing uniformity of economic institutions is still another issue that will only become clearer in the next few years.

International cooperative agreements[7]

As a response to the danger of inter-country impact and contagion, there are now more calls for coordination among governments or among branches of governments such as central banks. The recent call for an Asian Currency Stabilization Fund is an example of this emerging need in the face of the new world environment. As economic managers look at the issues involved, however, they discover that the benefits can only be acquired by giving up some flexibility and prerogatives. For example, financiers and managers of an international fund would need to be satisfied that a country using its access to the fund will institute the reforms needed to negate further or continuous need to return. This will require that the fund's or other countries' representatives examine and analyze the borrower's reports and policies. Thus, some sovereignty and flexibility will have to be given up. Any other international arrangement will require some similar loss of sovereignty in order to overcome what economists call the "incentive incompatibility problem." That is, if you are given the resources to ease your difficulties why will you work hard to get out of your situation?

Still another suggestion is to impose a tax or penalty for flows of very short term funds across borders. Most prominent among these is the "Tobin tax" proposed by Nobel economics laureate James Tobin of Yale University as early as 1978. The scheme aims to "put sand in the wheels" of international capital flows by imposing a minuscule tax — the initial proposal is for 0.2% — on every international transfer of capital. At that level, the tax will be immaterial for long-term investments but would grow heavier as the tenor of the funds being transferred became shorter. For example, it would be equivalent to a 105% annual tax if the funds are lent or transferred only for a day (compounded daily over 360 days). Thus, it would leave foreign direct investment and long-term loans and placements virtually untouched while making short-term speculation more expensive. Certain sectors have opposed it because it would lessen the efficiency of the international financial market, hamstringing its disciplinary aspects. Implementation may require that enough countries impose it; otherwise, the isolated number of economies imposing it may be avoided by the financial market, to their detriment. At the same time, it is fiscally attractive for countries with government revenue constraints because of the ease of collection.

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[6]For example, how the increasing independence of central banks will affect the coordination among the different macroeconomic agencies could depend on how the other institutions (e.g. laws and procedures) are configured in each country. The issue of "over steering" by both monetary and fiscal authorities in the face of central bank independence and its impact on internal policy coordination has been raised.

[7]Among central banks or other economic managers but more narrow than the concept of overall macroeconomic coordination. For that, see Paderanga (1997)

Another method of control is the imposition of reserve requirements (to be held with banks) on short-term capital flows, effectively reducing the rate of return on domestic short-term investments for foreign investors. This will hold back some of the more volatile inflows of funds which can be unstable. The central bank of Chile currently imposes the reserve requirement on all inflows but returns the amount kept in reserve as soon as some threshold time period is reached. Thus, the administrative cost of trying to distinguish between short and long-term flows is eliminated while the objective is still served.

It is increasingly apparent that while countries welcome the benefits of international financial integration and globalization, there will be a search for more instruments to allow policy makers some control over the massive flows and reversals of funds. To the extent that these efforts succeed in calming the markets and introducing more stability into the system, they may lead to more flows and more growth for the world economy. The result will also depend to the extent that these can be done without completely blocking the function of markets of instilling discipline and efficiency in all market participants, including policy makers who will need to focus on transparency, predictability and fundamental structural reforms.

The meaning of economic nationalism and the concept of the state

Financial globalization seems to be happening at a rapid pace and there is still no sign that countries will move strongly to stop or reverse these directions. The benefits are inducing governments and the private sector accede to the requirements of the emerging financial environment. At the same time, the implied changes in the character of economic management, on the activities of individual market players, and the increased volatility of the market imply changes in economic institutions and government flexibility and control. Even the concept of "citizenship" of corporations and individuals operating in various markets around the world is changing.

The concept of nationalism and its impact on how economic policies are crafted are also expected to undergo some changes. For one, with the need to show a level playing field for all market players, the design of programs for specific groups in the economy will become more stringent. For another, how do you design national taxes and benefits when it is difficult to determine which are your citizens? The problems posed by multi-national corporations such as transfer pricing, among others, will become more ubiquitous.

These changes imply that the concept of the state could undergo substantial changes if the movement towards even more financial globalization continues. As economic institutions are shaped, as they are changed in order to respond to external events and requirements, and as countries join more international cooperative agreements which require some loss of sovereignty and flexibility, the concept of the state will need to be reexamined and, perhaps, modified.

Conclusion

In this chapter we have seen how globalization and international financial integration are changing the volume and modes of international and financial interaction. Increased interaction results in beneficial effects for the world economy and individual countries. At the same time, these two related developments pose dangers to markets and individual participants. In order to minimize the dangers, governments need to adjust their intermediate policy objectives, towards less control, use new or modified instruments and change their style of managing their economies. Economic institutions, laws and regulations and even government instrumentalities may require modification. Some traditional concepts such as nationalism, state and citizenship may also undergo profound change.

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Appendix Table 1
Capital Flows to Developing Countries

	1983-88	1989-95	1991	1992	1993	1994	1995	1996
Developing countries								
Net Private Capital flows	15.1	107.6	136.1	127.4	141.2	118.3	151.2	200.7
Net direct investment	10.4	41.8	26.7	34.3	50.2	69.5	72.5	90.7
Net portfolio investment	3.4	44.0	36.1	53.0	89.3	83.6	16.9	44.6
Other net investments	1.3	22.1	73.2	41.6	2.3	-35.0	61.7	64.9
Net official flows	29.0	21.4	20.8	14.3	23.3	20.4	31.0	-3.8
Change in reserves	8.4	-42.7	-49.7	-45.7	-40.0	-42.2	-60.7	-82.3
Asia								
Net Private Capital flows	11.9	43.6	32.4	21.8	52.7	63.2	89.2	94.7
Net direct investment	3.6	25.0	12.1	17.7	34.0	43.6	49.5	54.8
Net portfolio investment	1.2	5.2	0.5	1.8	11.7	10.0	10.2	9.2
Other net investments	7.1	13.6	19.8	3.7	7.6	9.2	29.4	30.1
Net official flows	7.6	8.4	10.6	10.7	10.1	6.2	5.6	7.2
Change in reserves	-2.2	-23.8	-26.7	-15.1	-25.3	-47.4	-28.3	-43.2
Asia (As % of Developing Countries)								
Net Private Capital flows			23.8	17.1	37.3	53.4	59.0	47.2
Net direct investment			45.3	51.6	67.7	62.7	68.3	60.4
Net portfolio investment			1.4	3.4	13.1	12.0	60.4	20.6
Other net investments			27.0	8.9	330.4	-26.3	47.6	46.4
Net official flows			51.0	74.8	43.3	30.4	18.1	-189.5
Change in reserves			53.7	33.0	63.3	112.3	46.6	52.5

Source: May 1997 World Economic Outlook